

MASSACHUSETTS CONTRIBUTORY | RETIREMENT BOARD PROFILES

INTRODUCTION

The Board Profile section of the PERAC Annual Report provides a detailed assessment of some of the important indicators relative to the financial health of the retirement systems. The information provided in this report can enable board members to provide factual comment and advice to policymakers as various proposals relative to the retirement law are assessed. Through this and other studies, the Commission seeks to provide objective, comprehensive, and accurate data for use by all interested parties.

A WORD ON PORTFOLIO VALUATIONS

This Report details the investment returns for the retirement systems in 2013. In assessing investment performance, PERAC relies on the retirement boards to submit accurate and complete information about investment activity. PERAC numbers may differ from those provided to a board by its consultant because PERAC measures all assets, including monies not committed to investment management. In addition, as outlined below, for certain asset classes, PERAC like consultants, custodians and others charged with measuring investment performance is constrained to use valuations that are determined by the investment manager or general partner.

During the last few years the Securities and Exchange Commission (SEC) has taken a more aggressive stance towards the valuation of portfolio holdings by venture capital partnerships and other alternative investment management entities. That attention has focused on how the general partners value the portfolio investments which may be direct investments in companies or, in the fund of funds situation, the partnerships to which assets have been committed.

There is no simple method of accurately valuing these holdings and the process is largely subjective. In one SEC initial public offering filing the Carlyle Group stated, "Valuation methodologies for certain assets in our funds can involve subjective judgments and the fair value of assets established pursuant to such methodologies may be incorrect, which could result in the misstatement of fund performance."

In determining the value of investments to be disclosed in financial statements in venture capital, hedge funds and other alternative asset classes, partnerships often follow the American Institute of Certified Public Accountants Audit and Accounting Guide. Pursuant to that Guide all investments are to be carried at "fair value". Generally Accepted Accounting Principles (GAAP) defines "fair value" as the price that would be received in a market and sets forth a hierarchy of valuation techniques based on whether the inputs to be used are based on independent market sources (observable) or the general partners' market assumptions (unobservable). Thus, unlike market priced securities whose value is set forth in the newspaper each day, the limited partner (retirement board) must rely on the general partner to value these types of investments.

"Fair Value" is somewhat of a misleading term as it implies a more scientific process than is in fact used to value most holdings and can appear to some limited partners as a variation of market value. It most definitely is not.

"Fair Value" is somewhat of a misleading term as it implies a more scientific process than is in fact used to value most holdings and can appear to some limited partners as a variation of market value. It most definitely is not. The process outlined below as "Level 3" has been developed precisely because through much of the partnership's existence there is no market price and no independent market pricing mechanism exists. This is why auditors use phrases such as "For investments within Level 3 the methods described may produce a fair value measurement that may not be indicative of the ultimate realizable value" to describe what credence to give to such valuations.

The three levels of the fair value hierarchy are as follows:

Level 1 – Inputs that reflect unadjusted quoted prices in active markets for identical assets or liabilities that the Fund has the ability to access at the measurement date;

Level 2 – Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly, including inputs in markets that are not considered to be active;

Level 3 – Inputs that are unobservable.

Auditors stress that "...estimated values may differ significantly from the values that would have been used had a readily available market for such investments existed or had such investments been liquidated, and these differences could be material to the financial statements." As a result audits of a fund that employs "Level 3" valuations may include the caveat that a material issue with respect to the financial statements exists because the ultimate realized value of the holdings may differ substantially from the value carried in the financial statements.

Retirement boards and others should be particularly leery of a financial statement in which all the holdings are valued through "Level 3". These concerns are amplified when the resulting valuation indicates a positive performance in most or all of the portfolio holdings.



Consequently performance measurement of these portfolios generally reflects these estimates as resources do not enable a full independent valuation of these holdings which, by their illiquid nature, do not possess the characteristics of more marketable instruments.

PERFORMANCE IMPACT

This has major implications for the returns of retirement systems that have allocated a substantial portion of assets to assets that are valued in this manner. As noted it is impossible for PERAC, custodians, boards and consultants to conduct independent valuations of the portfolio companies that comprise these alternative investment portfolios. The greater allocation to these investments, the greater the likelihood that the overall return of the system will be impacted by the use of values determined in the manner outlined above.

ACTUARIAL

As always, actuarial information details the fiscal condition of the systems, which can play a direct role in state and local budgets. The funded ratio indicates the extent to which assets cover system liabilities. When the system will pay off its unfunded liability and what type of funding schedule is being used are also noted. PERAC has consistently urged boards to conduct actuarial valuations in order to provide an up-to-date assessment of the fiscal condition of the system. The actuarial information is based on information received or available as of April 1, 2014.

The Funding Schedule item reflects the amortization schedule for the Unfunded Actuarial Liability (UAL). For example, 1.5% increasing with a year fully funded of 2030 means the UAL is being amortized on a 1.5% annually increasing basis to FY30.

A number of systems utilize phase-in schedules in which payments increase more rapidly over the first few years of the schedule than later in the schedule. We reflect those schedules using the ultimate amortization schedule and note there is a phase-in. For example, “4.0% Increasing Phase-in” with a year fully funded of 2035 could mean the total appropriation increases 8.0% per year for 4 years and then the remaining unfunded liability is amortized on a 4.0% annual increasing basis until FY35. Twenty-two systems currently use a phase-in approach and both the percentage increase and number of years before the amortization begins vary. Schedules described as “Total Increasing” mean the annual appropriation increases by the amount indicated, which may vary, for the entire schedule. Thirty systems have such a schedule. In total, about one half of systems utilize a phase-in and/or total increasing schedule.

PERAC approved 50 new funding schedules and processed 25 actuarial valuations in 2013. The valuations complemented the 26 valuations performed by private actuaries. The Actuarial Unit also completed the annual actuarial valuation of the Commonwealth’s pension liability. Throughout the year, PERAC responded to many legislative and gubernatorial requests for analysis of legislation and made presentations at several forums.

MEDICAL PANELS/POST RETIREMENT EARNINGS

In addition to the information detailed in the Profiles, PERAC, as always, has been busy assisting the boards in other areas. In 2013, 668 medical panel requests were processed and 1501 comprehensive medical evaluations were conducted. This led to the approval of 585 disability applications and 64 accidental death claims. There have been 45 medical re-examinations of disability retirees.

Such medical evaluations and examination resulted in 3 members returning to work saving \$113,892.

PERAC is responsible for the post-retirement monitoring of disabled retirees. One aspect of that task is enforcing the earnings limits set forth in Chapter 32. In 2013, PERAC analyzed 15,599 earnings reports, 3,958 retirees reported earnings and 157 earned in excess of the statutory limits. An additional 59 retirees failed to comply with the reporting requirement. This resulted in the recovery of \$1,250,737 in excess earnings and \$1,770,132 for non-compliance. In addition 35 retirees waived their allowance saving \$546,942.

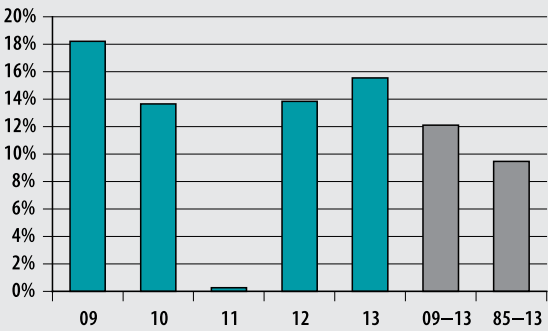
AUDITS

In 2013, PERAC conducted 33 audits of retirement systems. In addition, 12 follow-up audits were issued. In the last few years the Commission has awarded Certificates of Achievement to those systems found by our auditors to be operating in an exemplary fashion. In 2013 we issued 10 Certificates of Achievement. As always, PERAC audit staff conducted annual seminars on the preparation of the Annual Statement, which included training regarding issues arising from the most recent pension reforms and the Attorney General’s revised open meeting law regulations addressing remote participation.

COMPOSITE INVESTMENT PROFILE

- ▶ Commonwealth of Massachusetts
- ▶ Public Employee Retirement Systems and Pension Reserves Investment Trust

INVESTMENT RETURN (2009-2013, 5 YEAR AND 29 YEAR AVERAGES)



INVESTMENT

▶ 2013 Return	15.57%
▶ 2013 Market Value	\$71.1 B
▶ 2009-2013 (Annualized)	12.13%
▶ 1985-2013 (Annualized)	9.49%

ASSET GROWTH (2004-2013) (MARKET VALUE IN BILLIONS)

